**TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**

# The Internal Revenue Service Has Improved Processing and Review of Small Business Health Care Tax Credit Claims; However, Use of the Credit Has Decreased Significantly

**July 24, 2017**

**Reference Number: 2017-33-044**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

**Redaction Legend**:
1 = Tax Return/Return Information
2 = Law Enforcement Techniques/Procedures and Guidelines for Law Enforcement Investigations or Prosecutions.

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# HIGHLIGHTS

**THE INTERNAL REVENUE SERVICE HAS IMPROVED PROCESSING AND REVIEW OF SMALL BUSINESS HEALTH CARE TAX CREDIT CLAIMS; HOWEVER, USE OF THE CREDIT HAS DECREASED SIGNIFICANTLY**

# Highlights

**Final Report issued on July 24, 2017**

Highlights of Reference Number: 2017-33-044 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

## IMPACT ON TAXPAYERS

Systemic controls have allowed the IRS to identify errors or questionable issues related to the Small Business Health Care Tax Credit. However, some post-processing filters are not working as intended, which increases the risk that unnecessary examinations may be conducted. Unnecessary examinations waste resources and increase taxpayer burden.

## WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS's controls were effective in identifying and examining tax returns with erroneous Small Business Health Care Tax Credits. This review is part of our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Implementing the Affordable Care Act and Other Tax Law Changes.

## WHAT TIGTA FOUND

Systemic controls that were implemented through math error authority provide the IRS an opportunity to systemically identify calculation errors and, when certain criteria have not been met, lead to adjustment or disallowance of claimed credits. From Tax Year 2011 through Tax Year 2014, the IRS identified more than 41,500 tax returns for which the credit necessitated review and potential correction. TIGTA's analysis found that the number of Small Business Health Care Tax Credits allowed by the IRS in error on Form 1040, *U.S. Individual Income Tax Return*, and Form 1120, *U.S. Corporation Income Tax Return*, has decreased.

TIGTA also found that three of the IRS's post-processing filters used to identify questionable issues related to the Small Business Health Care Tax Credit, which may increase a tax return's potential for examination, were not working as intended. When post-processing filters incorrectly identify tax returns as noncompliant, unnecessary examinations may be conducted, wasting resources and placing a burden on taxpayers.

Claims for the Small Business Health Care Tax Credits have declined significantly. In March 2010, it was estimated that claims for the credit would average $4 billion annually. The estimate was later revised to $1 billion annually for Fiscal Years 2016 through 2025. However, IRS systems indicate that claims for the Small Business Health Care Tax Credit totaled approximately $519 million in Tax Year 2010, and decreased to approximately $120 million as of Tax Year 2014. Future claims of the credit may decrease even further. Effective in Tax Year 2014 and beyond, employers can only claim the credit for two consecutive years.

## WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Examination, Small Business/Self-Employed Division, review post-processing filters designed to identify potentially questionable issues related to the credit and correct programming issues when errors are identified.

In response to our report, IRS management agreed with our recommendation and plans to take corrective action by analyzing each filter to determine if it is performing as intended and make corrections where necessary. The IRS plans to continue monitoring the filters to determine if further corrections are necessary.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**

**WASHINGTON, D.C. 20220**

July 24, 2017

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

**FROM:** Michael E. McKenney
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – The Internal Revenue Service Has Improved Processing and Review of Small Business Health Care Tax Credit Claims; However, Use of the Credit Has Decreased Significantly (Audit # 201530336)

This report presents the results of our review to determine whether the Internal Revenue Service's controls were effective in identifying and examining tax returns with erroneous Small Business Health Care Tax Credits. This review is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Implementing the Affordable Care Act and Other Tax Law Changes.

Management's complete response to the draft report is included as Appendix V. Copies of this report are also being sent to the Director, Office of Audit Coordination, for appropriate distribution within the Internal Revenue Service.

If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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## Appendices

# *Abbreviations*

| | |
|---|---|
| ERS | Error Resolution System |
| FTE | Full-Time Equivalent |
| FY | Fiscal Year |
| IRS | Internal Revenue Service |
| SB/SE | Small Business/Self-Employed |
| TIGTA | Treasury Inspector General for Tax Administration |
| TY | Tax Year |

# Background

In March 2010, the Patient Protection and Affordable Care Act[1] was enacted. This health care legislation, along with amendments in the Health Care and Education Reconciliation Act of 2010, contains provisions generally intended to increase access to health insurance coverage through insurance market reforms and the creation of health insurance exchanges. To assist in covering the cost of health insurance coverage, the legislation also contains provisions for tax credits to individuals, tax-exempt organizations, and businesses. One such credit, the Small Business Health Care Tax Credit, was created to reimburse eligible small employers for a portion of their employee health insurance expenses.[2]

For Tax Year (TY) 2010 through TY 2013, the maximum potential credit is 35 percent of premiums for a qualified health care plan paid by eligible small business employers and 25 percent of premiums paid by eligible small tax-exempt employers, such as charities.[3] For tax years beginning in TY 2014 or later, the maximum potential credit increases to 50 percent of premiums and 35 percent of premiums paid by eligible small business and small tax-exempt employers, respectively. In addition, beginning in TY 2014, an eligible employer can only claim the credit for two consecutive years.

Once a taxpayer has determined eligibility requirements and completed Form 8941, *Credit for Small Employer Health Insurance Premiums*, to determine his or her credit, the amount is then transferred to other forms. In the case of most businesses and individuals, the credit is reported on Form 3800, *General Business Credit*, which is then included (to the extent allowed) on Form 1040, *U.S. Individual Income Tax Return*; Form 1041, *U.S. Income Tax Return for Estates and Trusts*; or Form 1120, *U.S. Corporation Income Tax Return*. Partnerships report the credit as part of Schedule K, *Partners' Distributive Share Items*, on Form 1065, *U.S. Return of Partnership Income*, and flow the credit to their partners using Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* S corporations report the credit on Schedule K, *Shareholders' Pro Rata Share Items*, on Form 1120S, *U.S. Income Tax Return for an S Corporation*, and flow the credit to shareholders using Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc*.

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[1] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.
[2] The Small Business Health Care Tax Credit is provided for in Internal Revenue Code Section (§) 45R. A glossary of terms is included as Appendix IV. The Small Business Health Care Tax Credit is hereafter referred to as the credit.
[3] The maximum credit is limited to the percentage of the lesser of the actual premiums paid or the average premium in the employers rating area as determined by the Secretary of Health and Human Services.

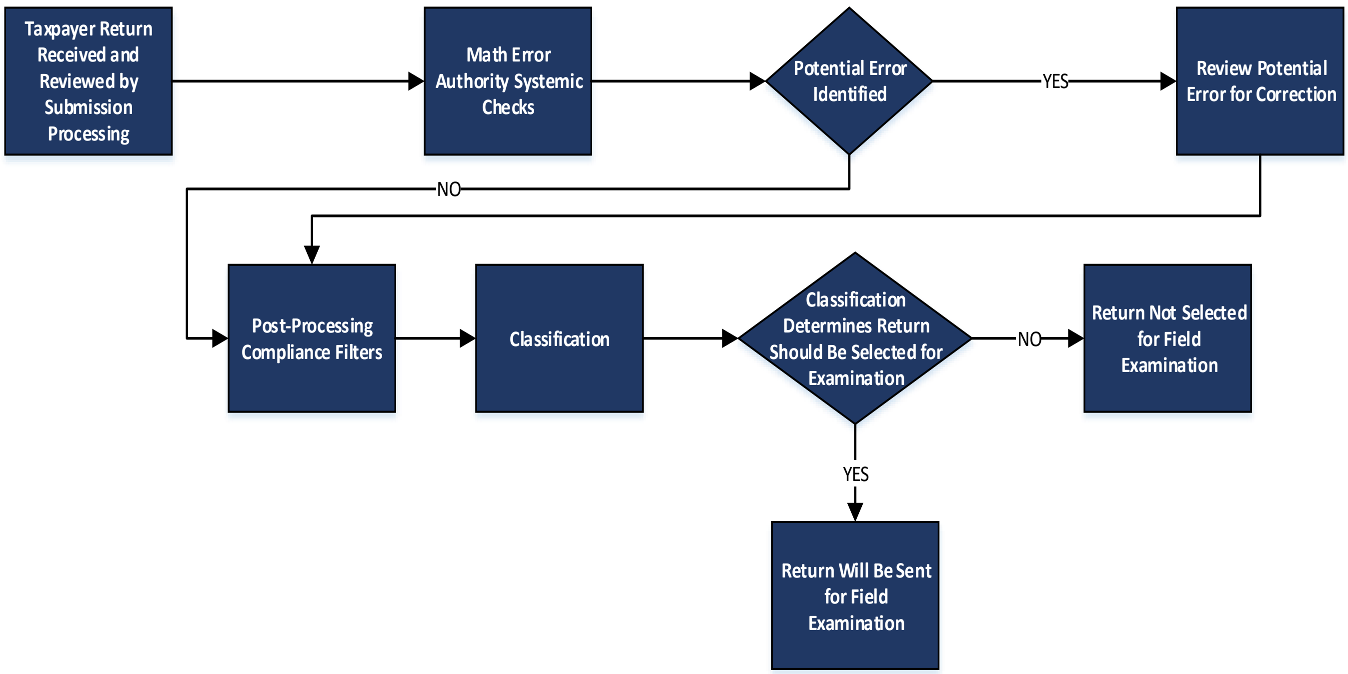
## The process for identifying and examining tax returns with potentially erroneous credits

In September 2011, the Treasury Inspector General for Tax Administration (TIGTA) reported that, overall, the Internal Revenue Service (IRS) had successfully implemented the credit, but some improvements were needed.[4] TIGTA's recommendations included that the IRS should: 1) determine whether math error authority is appropriate to disallow the credit when employment tax returns have not been filed or when other supporting documents have not been provided; 2) ensure that all line items from Form 8941 are transcribed into IRS systems to allow more basic checks of arithmetic accuracy during tax return processing; and 3) track Professional Employer Organization relationships by inputting cross-referenced Employer Identification Numbers on client business tax accounts. IRS management agreed with these recommendations and has taken corrective actions.

While the IRS is not transcribing all line items from Form 8941 into its systems, it is transcribing the majority of line items, which allows the IRS to use systemic controls to apply mathematical error checks during processing. As shown in Figure 1, tax returns with a Form 8941 claiming the credit are first received and reviewed by the Submission Processing[5] function before they are potentially routed to the Small Business/Self-Employed (SB/SE) Division's Field Examination function.

[4] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).
[5] The Submission Processing function is part of the IRS's Wage and Investment Division.

**Figure 1: The IRS's General Processing of Tax Returns Claiming the Credit and Routing to SB/SE Division Field Examination**




*Source: TIGTA analysis of the IRS's general processing of returns claiming the credit.*

Since the processing of TY 2011 tax returns for individuals and TY 2013 for business tax returns, the Submission Processing function has used math error authority to establish a set of systemic controls for performing error checks.[6] These systemic checks evaluate a taxpayer's computation of the credit using information transcribed into IRS systems from Form 8941. For example, to qualify for the credit, an employer must meet the following characteristics:

- Have fewer than 25 full-time equivalent (FTE) employees for the taxable year.
- Have average annual wages of less than $50,000 per FTE.[7]

[6] Under Internal Revenue Code § 6213(b) and (g), math error authority allows the IRS to deny questionable or unsubstantiated claims for certain refundable credits arising out of mathematical or clerical errors. This is accomplished by sending notice to taxpayers explaining the changes. Taxpayers then have 60 days, after notice is sent, to request an abatement of the tax if they disagree with the correction. Failure to do so results in an assessment that cannot be challenged in Tax Court.

[7] Average annual wages are indexed for inflation beginning in TY 2014, when the amount was increased to $51,000; in TY 2015, it was increased to $52,000.

If a taxpayer reports more than 10 FTEs, or average annual wages of more than $25,000 on Form 8941, the credit is gradually phased out for TYs 2010 through 2013.[8] Once a taxpayer reports 25 or more FTEs, or average annual wages of over $50,000 on Form 8941, the credit is phased out and the IRS has the authority to adjust the credit to zero for TYs 2010 through 2013.[9] In addition, the IRS also has the authority to disallow the credit when taxpayers do not provide the required information, such as line items left blank on Form 8941, or adjust the credit when a mathematical error is identified that affects its accuracy. Once the systemic checks identify a potential error, an Error Resolution System (ERS) tax examiner with the Submission Processing function reviews the potential error for correction. If a correction is made, the Submission Processing function sends a letter to the taxpayer explaining the reason for the change to the tax return. If the ERS tax examiner determines that no correction is needed, the tax return is allowed to continue processing.

Regardless of the outcome from math error authority systemic checks, all tax returns claiming the credit are next analyzed using the IRS's post-processing compliance filters, which are intended to identify potential inaccuracies (including questionable credits). For example, post-processing filters include testing whether the required payroll tax returns were filed or whether specific threshold limitations were considered and applied by the taxpayer.

Potential issues with only the credit claimed by a taxpayer may not be enough to warrant an examination as tax returns are evaluated, in their entirety, for a number of factors. The IRS works to make the most efficient use of staffing and resources by selecting tax returns for which its examiners are likely to find areas of noncompliance and for which an examination may result in changes to one or more items reported on the tax return. Tax returns with increased examination potential are made available to the Examination Classification function.[10] As workload needs for field examiners arise, the Examination Classification function evaluates and decides whether a tax return should be selected for examination or accepted as filed based on an evaluation of the tax return as a whole as well as individual line items.

This review focuses on the IRS's administration of Small Business Health Care Tax Credit claimed by small business taxpayers. Administration of tax-exempt taxpayers claiming this

[8] For TY 2014, the credit begins to gradually phase out if a taxpayer reports more than 10 FTEs or average annual wages of more than $25,400. For TY 2015, the credit begins to gradually phase out if a taxpayer reports more than 10 FTEs or average annual wages of more than $25,800.
[9] For TY 2014, the credit is completely phased out if a taxpayer reports 25 or more FTEs or average annual wages of $51,000 or more. For TY 2015, the credit is completely phased out if a taxpayer reports 25 or more FTEs or average annual wages of $52,000 or more.
[10] Not all tax returns are processed through the classification process, such as tax returns determined to be low risk based on the IRS's scoring system and tax returns for which no other examination criteria are met. As IRS examination groups identify a need for additional inventory, an order is placed to request that additional inventory be processed; these tax returns will then be processed through classification.

credit was previously reviewed by TIGTA.[11] This review was performed with information obtained from the SB/SE Division Headquarters in Lanham, Maryland, and from the Wage and Investment Division Headquarters in Atlanta, Georgia, during the period July 2015 through February 2017. We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[11] TIGTA, Ref. No. 2014-13-005, *Potentially Improper Health Care Credit Claims by Tax-Exempt Organizations Are Generally Being Identified for Review, but Improvements Are Needed* (Jan. 2014).

# Results of Review

The IRS continues to identify and prevent erroneous Small Business Health Care Tax Credits. Implementation of systemic controls and review by ERS tax examiners may have helped to decrease the number of credits accepted in error; however, the decline in the number of credits being claimed is reducing the need for these controls and the likelihood that the credit may be accepted in error. In addition, post-processing filters used to detect instances of taxpayer noncompliance were not always working as intended.

## Controls Have Been Implemented to Improve Claim Processing, and Examiners Are Considering and Reviewing the Small Business Health Care Tax Credit

### Systemic controls have been implemented for Forms 1040 and 1120

Since its implementation, the IRS made enhancements to and worked to improve administration of the credit. Programming of systemic controls associated with math error authority were implemented within the ERS and applied to Forms 1120 and 1041 filed for TY 2013. Math error authority controls for Form 1040 were implemented for tax returns filed for TY 2011.[12] In addition, the majority of Forms 8941 are now transcribed onto IRS systems, which allows more accuracy checks of the credit during processing.

*********************************2*********************************
*********************************2*************************************
*********************************2*******************************
****2****.[13]

The systemic controls that were implemented through math error authority provide the IRS an opportunity to systemically identify calculation errors or when certain criteria have not been met, leading to adjustment or disallowance of claimed credits. Although the IRS does not keep track of specific tax returns or adjustments made to the credit as a result of math error authority, as shown in Figure 2, from TY 2011 through TY 2014 the IRS identified 41,551 Forms 1040 and

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[12] Controls applied to TY 2013 tax returns were implemented during Processing Year 2014, and controls applied to TY 2011 tax returns were implemented during Processing Year 2012.

[13] In Processing Year 2011, the IRS received approximately 209,600 Forms 1120 and 1040 claiming the credit; during the same period, Forms 1065 and 1120S claiming the credit totaled approximately 1,100. By Processing Year 2015, Forms 1120 and 1040 tax returns claiming the credit totaled approximately 13,000, while the combined Forms 1065 and 1120S totaled approximately 21,000.

1120 tax returns for which the credit necessitated review and potential correction by ERS tax examiners.

**Figure 2: Summary of Forms 1040 and 1120 With Potentially Erroneous Credits Identified Using Math Error Authority During TYs 2011–2014**[14]

| Type of Tax Return | Tax Year/ Processing Year | Potential Errors Identified |
|---|---|---|
| Form 1040 | 2011/2012 | 14,685 |
| | 2012/2013 | 13,954 |
| | 2013/2014 | 882[15] |
| | 2014/2015 | 759 |
| Total | | 30,280 |
| | | |
| Form 1120 | 2011/2012 | Not Implemented |
| | 2012/2013 | Not Implemented |
| | 2013/2014 | 2,687 |
| | 2014/2015 | 8,584[16] |
| Total | | 11,271 |

*Source: IRS Submission Processing.*

[14] TY 2011 (Processing Year 2012) was the first year math error authority for the credit was implemented for Forms 1040. TY 2013 (Processing Year 2014) was the first year math error authority for the credit was implemented for Forms 1120. Figure 2 reflects counts provided by the IRS for three of six potential error codes related to math error authority for this credit.

[15] Beginning in Processing Year 2014, a tolerance amount was included within the programming of the error code related to Forms 1040. The tolerance amount resulted in fewer potential errors and acceptance of tax returns with minor differences between the credit amount claimed by the taxpayer and the credit amount computed by IRS systems based on other information in the tax return.

[16] Systemic controls for Forms 1120 claiming the credit were implemented in Processing Year 2014 and were subsequently expanded upon in Processing Year 2015. The additional control increased the number of potential errors identified through the IRS's systemic controls.

Errors that might be identified and result in the credit being disallowed include incomplete data or missing supporting documents. The errors identified using math error authority in Figure 2 include but are not limited to situations in which:

- Form 8941 is missing or incomplete.
- The taxpayer is not eligible for the credit because more than 25 FTE employees for the tax year are reported on Form 8941, line 2.
- The taxpayer is not eligible for the credit because more than $50,000 ($51,000 for TY 2014 and $52,000 for TY 2015) of average annual wages paid per FTE is reported on Form 8941, line 3.
- The taxpayer is not eligible for the credit because the taxpayer did not indicate participation with the Small Business Health Options Program on Form 8941, line A.
- The credit amount computed on Form 8941 does not match the amount transferred to Form 3800.

To test whether the systemic controls related to programming of math error authority to identify potential errors and the review by ERS tax examiners were working effectively for submissions of tax returns with Forms 8941, we obtained and analyzed the population of individual and business tax returns claiming the credit.[17] Our analysis identified tax returns that did not meet the following two key criteria for claiming the credit and were not disallowed during review by ERS tax examiners.

1. The number of FTEs reported on Form 8941 was less than 25.
2. The average annual wages reported on Form 8941 were less than $50,000 ($51,000 for TY 2014 and $52,000 for TY 2015).

Both of these are criteria that math error authority systemic controls should identify and would be instances in which ERS tax examiners may disallow the credit.

Our analysis found that the number of credits allowed in error on Forms 1040 and 1120 by ERS tax examiners has decreased significantly. For TY 2012, prior to the implementation of systemic controls and further review by ERS tax examiners, we identified that the IRS may have accepted 24 Form 1120 tax returns claiming approximately $86,000 in credits which did not meet one of the two key criteria. Tax returns accepted in error for TY 2015 decreased 79 percent, to five tax returns claiming approximately $44,000 in credits.

Similarly, prior to implementation of systemic controls, the IRS accepted 28 Form 1040 tax returns for TY 2010, claiming approximately $77,000 in potentially erroneous credits. Since

[17] We obtained and analyzed Forms 1040, 1120, 1120S, and 1065, but not Form 1041, received during Processing Years 2011 through 2016.

implementation of systemic controls, the number of Form 1040 tax returns accepted in error in TY 2015 has decreased *************************1*************************
******1*******.

Additional systemic controls and subsequent review by ERS tax examiners appear to have resulted in a decline in the number of tax returns being accepted in error. However, an overall decline in the number of credits being claimed, discussed later in this report, has resulted in fewer credits that are subject to these controls.

## SB/SE Division field examiners are considering and reviewing the credit

In addition to math error authority used to evaluate claimed credits during processing, the IRS developed a compliance plan for the credit that was approved in March 2013. As part of the compliance plan, SB/SE Division personnel specifically selected for examination those tax returns claiming the credit. The SB/SE Division analyzed the examination results to ensure that taxpayers were properly calculating and claiming the credit. The analysis determined that examinations of taxpayers claiming the credit were resulting in smaller adjustments to tax liabilities (*i.e.*, less taxpayer noncompliance) and significantly more no-change results when compared to examinations of a similar population of taxpayers who were not claiming the credit.[18] As a result, the SB/SE Division discontinued the process of selecting tax returns for examination based solely on the fact that the taxpayer had claimed the credit.

Since Fiscal Year (FY) 2013, the credit is generally reviewed only if it is identified as an issue during classification or as a large, unusual, or questionable item during the course of an examination. Large, unusual, or questionable items depend on an examiner's evaluation of the tax return as a whole and the separate items that comprise the tax return. Some factors to be considered are the size of the item, the inherent character of the item, and any evidence of intent to mislead.

To evaluate the IRS's effectiveness in examining the credit, we reviewed a sample of tax returns claiming the credit. We first obtained an extract of Forms 1040 and 1120 tax returns claiming the credit filed during Processing Years 2011 through 2014 and examined by SB/SE Division field examiners during FY 2015.[19] In order to increase the likelihood that the credit may have been identified and reviewed during the examination, our extract was then limited to tax returns for which the credit *************************2*****************************
***2**. To determine how examiners were considering and reviewing the credit when they were not prompted to do so, we excluded those tax returns classified under project codes that

[18] A no-change is the outcome of an examination when a taxpayer has substantiated all of the items being examined, and the IRS does not recommend adjustments or changes to the taxpayer's tax return as a result of the audit.
[19] Our extract was limited to examinations conducted by SB/SE Division field examiners and excluded examinations conducted by SB/SE Division campus examiners as well as training cases.

would have specifically classified the credit for review. We identified a population of 287 tax returns meeting those criteria.

We reviewed a statistically valid sample of 100 of the 287 tax returns to ensure that examiners were effectively assessing risk and using their best judgment to review the credit only when appropriate and that they were not expending resources to examine the credit when it was immaterial to the tax return.[20] Our results indicate that examiners are generally considering the credit during examinations when appropriate. Specifically, for 97 of the 100 sampled tax returns, examiners appropriately reviewed the credit or determined that review was not necessary because the credit did not meet the criteria of a large, unusual, or questionable item when considered with the taxpayer's tax return as a whole. For the remaining three sampled tax returns, all of which were Form 1120 tax returns, we concluded that the examiner should have reviewed the credit as a large, unusual, or questionable item but did not.

While we identified three instances in which examiners should have given the credit more consideration in relation to the tax return as a whole, we believe that SB/SE Division examiners are generally considering and incorporating the credit within the scope of examinations when necessary. Given the limited size of the credit and its decreasing use by taxpayers, the IRS's practice of reviewing the credit when appropriate allows it to use its resources on more productive examination issues.

## Some Post-Processing Filters Are Not Working As Intended

Systemic controls for math error authority take place within the Submission Processing function. Once a tax return has been posted to a taxpayer's account, the SB/SE Division has systemic post-processing filters to identify issues that may increase a tax return's potential for examination. The filters include identifying potentially questionable issues related to the credit, such as whether the taxpayer met key criteria, filed an employment tax return, claimed a credit in excess of the threshold amount, or compared premiums paid to the average group market in their State's county. Post-processing filters are used to evaluate all tax returns with a Form 8941.

The IRS provided a listing of more than 178,000 tax returns, received from Processing Year 2011 through Processing Year 2014, for which post-processing filters identified a potential error. We identified and reviewed 86 of those tax returns that were examined and closed during FY 2015 for which the claimed credit was in *******2****** and a potential error was associated with the credit. Our review identified three post-processing filters that were not working as intended due to programming issues, resulting in potentially unwarranted scrutiny of the credit.

[20] Our sample of 100 tax returns was selected using a confidence level of 95 percent, a precision rate of ± 7.9 percent, and an error rate of 50 percent. For review purposes and due to variances in claimed credits, we stratified our sample by the type of form (Forms 1040 or 1120) and the claimed credit amount.

- One filter was designed to identify when taxpayers claimed the credit but did not have a requirement to file employment tax returns, indicating that either the taxpayers may not have the qualifying employees required to claim the credit or the taxpayers had qualifying employees but were not meeting the filing requirement related to employment tax returns. There were four instances in which this filter incorrectly identified this situation when the taxpayers actually had employment tax return filing requirements.
- Another filter was designed to evaluate whether the taxpayers claimed zero FTEs or left the line blank on Form 8941 and at the same time considered fewer than 10 individuals as employees, indicating that the taxpayers may not have calculated the number of eligible employees required to claim the credit or the form was incomplete. We identified four instances in which this filter incorrectly identified taxpayers as having filed zero FTEs or left the FTE amount blank when in fact FTEs had been claimed on Form 8941, resulting in unwarranted scrutiny for these tax returns.
- Another filter was established to identify taxpayers who did not use the lower of the average insurance premium paid or the average group market premium in their State's county (as provided in the instructions to Form 8941) in calculating their credit, indicating that the taxpayers may have overstated the allowable credit. This filter incorrectly identified 17 taxpayers as having not performed this premium comparison when in fact the comparison had been performed.

When post-processing filters incorrectly identify tax returns as noncompliant, those tax returns may be at a greater risk for potential examination selection. Therefore, a tax return may be given additional scrutiny that is not warranted. During our fieldwork, the SB/SE Division had already begun reviewing the programming and correcting the filter failures we identified. If the filters are not regularly reviewed and corrected to properly evaluate tax returns, the risk increases that unnecessary examinations may be conducted, wasting resources and placing a burden on taxpayers.

## Recommendation

Recommendation 1***:*** The Director, Examination, SB/SE Division, should review post-processing filters designed to identify potentially questionable issues related to the credit and correct programming issues when errors are identified.

***Management's Response:*** The IRS agreed with this recommendation. Specifically, the IRS is in the process of analyzing each filter to determine if it is performing as intended. Several filters have already been identified, and the IRS is working to make corrections for the current year. The IRS will also continue monitoring the filters for TY 2017 tax returns, filed in Calendar Year 2018, to determine if further corrections are necessary.

## Use of the Small Business Health Care Tax Credit Has Declined Significantly

The Congressional Budget Office and the staff of the Joint Committee on Taxation estimated in March 2010 that the total amount of the credit would average $4 billion annually for FYs 2010 through 2019, but later revised the estimate in March 2015 to $1 billion annually for FYs 2016 through 2025.[21] As shown in Figure 3, IRS systems indicate that claims for the credit totaled approximately $519 million in TY 2010 and decreased 77 percent to approximately $120 million as of TY 2014, the last full year of available data. While TY 2015 amounts were not complete, claims for the credit appear to be on a declining trend.[22]

**Figure 3: Number of Taxpayers and Amount of Claimed Credits for TYs 2010–2015[23]**

| Tax Year | Number of Taxpayers Claiming the Credit | Total Credit Amount Claimed | Average Credit Claimed per Taxpayer |
|---|---|---|---|
| 2010 | 188,303 | $519,333,025 | $2,758 |
| 2011 | 191,978 | $555,229,855 | $2,892 |
| 2012 | 181,826 | $526,480,273 | $2,896 |
| 2013 | 173,492 | $511,309,746 | $2,947 |
| 2014 | 28,303 | $119,874,412 | $4,235 |
| 2015 | 14,001 | $56,186,339 | $4,013 |

*Source: IRS Research, Applied Analytics, and Statistics.*

[21] Joint Committee on Taxation estimated revenue effects, JCX-17-10, March 20, 2010, and JCX-17-10, March 6, 2015.
[22] Data for TYs 2010 through 2015 is cumulative through August 27, 2016.
[23] Data in Figure 3 includes exempt and non-exempt employer taxpayers but does not include credits on tax returns claimed by shareholders or partners.

Stakeholders have pointed to several reasons why the credit may not have been claimed by small businesses at the rates previously estimated, including, but not limited to:[24]

1. Lack of knowledge and confusion about who qualifies for the credit as well as how to claim it.
2. Minimal tax benefit when compared to the time and cost involved in claiming the credit.

The credit is nonrefundable for individual or business tax returns, so those taxpayers who owe no tax in one year may not immediately benefit from what is generally a small credit and instead might carry the credit back to a previous year or forward to a future year to reduce a tax liability.[25]

In addition, the decline in the number of taxpayers claiming the credit in TY 2014 may be tied to a change that went into effect that year. Beginning in TY 2014, in order to qualify for the credit, a small business must purchase coverage for its employees through the Small Business Health Options Program Marketplace. This change would likely have increased the administrative burden to small businesses and, along with the minor tax benefits, may have contributed to the decline of credits claimed as noted above.

Moreover, future claims of the credit may decrease even further. Effective in TY 2014 and beyond, employers can only claim the credit for two consecutive years. This change limits taxpayers who may have claimed and realized benefits of the credit in the past. As such, the number of claims may decrease significantly in TY 2016 and beyond.

Decreased use of the credit by taxpayers has minimized the effect of IRS errors associated with processing and reviewing the credit. Unless the trend in taxpayers claiming the credit reverses, the benefits of expanding controls may not outweigh the cost of implementation. The IRS, and the SB/SE Division specifically, should continue to be conscious of new legislation or environmental factors that could increase use of the credit. Should such changes take place, further controls may be warranted and should be considered at that time.

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[24] Government Accountability Office Testimony Before the Subcommittee on Economic Growth, Tax and Capital Access, Committee on Small Business, House of Representatives, GAO-16-491T, *Small Employer Health Tax Credit: Limited Use Continues Due to Multiple Reasons* (Mar. 2016). IRS Office of Program Evaluation and Risk Analysis: *Affordable Care Act Focus Groups: The Small Business Health Care Tax Credit* (Oct. 2011). Government Accountability Office Report to Congressional Requesters, GAO-12-549, *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity* (May 2012).

[25] The credit is refundable to tax-exempt organizations, but only to the extent it does not exceed the income tax withholding and Medicare tax liability. A refundable credit allows taxpayers to reduce their tax liability to below zero and thus receive a tax refund even if no income tax was withheld or paid.

## Appendix I

# Detailed Objective, Scope, and Methodology

Our objective was to determine whether the IRS's controls were effective in identifying and examining tax returns with erroneous Small Business Health Care Tax Credits.[1] To accomplish this objective, we:

I. Determined the applicable policies, procedures, and controls in place for processing and examining tax returns claiming the credit. This included reviewing the Internal Revenue Manual, interviewing IRS management and employees, and obtaining the status of ongoing efforts relating to examining tax returns claiming the credit.

II. Determined whether controls for math error authority are effective in identifying potentially erroneous credits.

   A. Obtained documentation of the IRS systemic controls, such as the listing of the error codes and descriptions of the system programming.

   B. Identified the population of Forms 1040, *U.S. Individual Income Tax Return*, Forms 1120, *U.S. Corporation Income Tax Return*, Forms 1120S, *U.S. Income Tax Return for an S Corporation*, and Forms 1065, *U.S. Return of Partnership Income*, from the IRS's Individual and Business Returns Transaction Files, processed by the IRS from Processing Year 2011 through 2016, for which the taxpayer had claimed the credit.

   C. We validated selected information to the IRS's Integrated Data Retrieval System and also evaluated the sufficiency and reliability of the extract by comparing our extract results to Form 8941, *Credit for Small Employer Health Insurance Premiums*, summary data from the IRS's Compliance Data Warehouse. We noted minor differences (less than 1 percent) of the total number of Forms 8941 when compared with our extract. We also tested the claimed credits for reasonableness. Our testing included comparing the credit to other related information from the same tax return, such as the amount of the general business credit and the amount of tax liability.[2] Our final analysis of the claimed credits, which may have been accepted in error, excludes those credits that we reasonably considered to be incorrect due to transcription errors.

[1] See Appendix IV for a glossary of terms.
[2] The general business credit is made up of several business-related credits, one of which is the Small Business Health Care Tax Credit.

Having applied this reasonableness testing to the extracted information we considered the information reliable for our analysis.

D. We analyzed the tax returns for instances in which the tax return indicated 25 or more FTEs and average annual wages of $50,000 or more ($51,000 for TY 2014 and $52,000 for TY 2015) to determine whether the systemic controls were effective to prevent potentially erroneous credits from going undetected.

III. Determined whether post-processing filters were properly identifying potentially improper claims for the credit.

A. Identified the population of Forms 1040 and 1120 tax returns by obtaining an extract of the IRS's Individual and Business Returns Transaction Files received from Processing Years 2011 through 2014 that were examined by SB/SE Division field examiners and closed in FY 2015. Our population also reflected tax returns for which the claimed credit on the tax return was ************2********** was not expressly classified for review, and the tax return also failed a post-processing filter intended to identify potential errors with the credit.

B. We determined the extracted data were sufficient and reliable for the purposes of this review by validating selected information to the IRS's Integrated Data Retrieval System.

C. For tax returns that failed a post-processing filter and were selected for examination, we obtained and reviewed those tax returns with attached Forms 8941, along with the associated examiner case files (paper and electronic), to determine whether the credit was being calculated correctly and properly examined.

D. Reviewed case file information as detailed in III.C and held discussions with IRS staff to determine whether post-processing filters were operating as intended.

IV. Determined whether SB/SE Division field examiners are effective in validating the taxpayer's eligibility and the accuracy of the credit and are adequately assessing risk to review the credit when appropriate.

A. Using the data extracted in II.B, we identified a population of 287 Forms 1040 and 1120 tax returns from the IRS's Individual and Business Returns Transaction Files processed by the IRS from Processing Years 2011 through 2014. We filtered our data for tax returns with a credit of more ****************2*****************
**********2*******. We also filtered for tax returns that were examined by SB/SE Division field examiners and the examination was closed in FY 2015.[3]

[3] In order to determine how examiners were considering and reviewing the credit without prompting, we excluded those tax returns classified under certain project codes that would have specifically classified the credit for review.

B. We evaluated the sufficiency and reliability of the extract by comparing our extract results to Form 8941 summary data from the IRS's Compliance Data Warehouse. We noted minor differences (less than 1 percent) of the total Forms 8941 when compared with our extract and considered our extract sufficient and reliable for this review.

C. We selected a statistically stratified random sample of 100 Forms 1040 and 1120 tax returns from the population identified in IV.A to determine whether examiners were effectively assessing risk and using their best judgment to review the credit only when appropriate.[4] Our sample of 100 tax returns was selected using a confidence level of 95 percent, a precision rate of ± 7.9 percent, and an error rate of 50 percent. Our contracted statistician assisted with reviewing our sampling plan and confirmed the accuracy of our methodology.

D. Obtained and reviewed Forms 8941, tax returns, and associated case files (paper and electronic) of the sampled tax returns to determine whether the credit was being calculated correctly and was properly considered and reviewed during examination.

V. Reviewed prior reports and studies conducted by the TIGTA, the Government Accountability Office, and the IRS regarding the credit and determined the status of any corrective actions by the IRS in response to the reviews.

VI. Identified the potential reasons that the population of taxpayers claiming the credit has decreased since the credit was created. This included reviewing external reports and interviewing IRS management and employees.

## ***Internal controls methodology***

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS policies and procedures for processing and examining tax returns claiming the credit. We evaluated these controls by reviewing source materials, discussing controls with management, reviewing examination case files, and researching taxpayer accounts.

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[4] The 100 sampled tax returns consisted of a selection of 37 Forms 1040 and 63 Forms 1120. Tax returns selected from Forms 1040 consisted of 14 tax returns from Strata 1 (credits of at least $1,000 but not more than $2,999), nine tax returns from Strata 2 (credits of at least $3,000 but not more than $4,999), nine tax returns from Strata 3 (credits of at least $5,000 but not more than $9,999), and five tax returns from Strata 4 (credits of at least $10,000). Tax returns selected from Forms 1120 consisted of 18 tax returns from Strata 1 (credits of at least $1,000 but not more than $2,999), 18 tax returns from Strata 2 (credits of at least $3,000 but not more than $4,999), 23 tax returns from Strata 3 (credits of at least $5,000 but not more than $9,999), and four tax returns from Strata 4 (credits of at least $10,000).

**Appendix II**

## Major Contributors to This Report

Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
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Curtis Kirschner, Audit Manager
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Appendix III

## Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Deputy Commissioner, Small Business/Self-Employed Division
Director, Examination, Small Business/Self-Employed Division
Director, Office of Audit Coordination

## Appendix IV

# Glossary of Terms

| Term | Definition |
|---|---|
| **Classification** | A process used by the IRS's Examination functions to determine which tax returns should be selected for examination. |
| **Employer Identification Number** | A unique nine-digit number used to identify a taxpayer's business account. |
| **Employment Tax Returns** | Various Form 94X tax return series (primarily Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, and Form 941, *Employer's QUARTERLY Federal Tax Return*) filed by businesses to report items such as employer's Federal unemployment taxes and Federal taxes withheld. |
| **Examination** | A review of individual, partnership, and corporation tax returns that can occur through correspondence, interviews at an IRS office, or at the taxpayer's home or place of business, the purpose of which is to determine whether taxpayers accurately reported their tax liabilities. |
| **Examiners** | IRS employees who review tax returns to determine whether taxpayers accurately reported their tax liabilities. |
| **Fiscal Year** | Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30. |
| **Full-Time Equivalents** | An employment calculation used to determine credit qualification and amount. The general calculation is the total hours of service for the tax year for each employee, not more than 2,080 hours per employee, divided by 2,080 hours. See Form 8941 instructions for additional explanation and calculation details used for this credit. |
| **Integrated Data Retrieval System** | The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records. |

| Term | Definition |
|---|---|
| **Internal Revenue Code** | Title 26 of the United States Code enacted by Congress containing all relevant rules pertaining to estate, excise, gift, income, payroll, and sales taxes. |
| **Internal Revenue Manual** | Contains the policies, procedures, instructions, guidelines, and delegations of authority that direct the operation for all divisions and functions of the IRS. |
| **Processing Year** | The calendar year in which tax returns and other tax data are processed by the IRS. |
| **Professional Employer Organization** | An organization that enters into an agreement with an employer to perform some or all of the employment tax withholding, reporting, and payment activities related to workers performing services for the employer. Sometimes referred to as an employee leasing company, these organizations may also manage human resources, employee benefits, workers compensation claims, and unemployment insurance claims. |
| **Small Business/ Self-Employed Division** | The IRS organization that services self-employed taxpayers and small businesses by educating and informing them of their tax obligations, developing educational products and services, and helping them understand and comply with applicable tax laws. |
| **Submission Processing Function** | The data processing arm of the IRS. The function processes paper and electronic submissions, corrects errors, and forwards data to the Computing Centers for analysis and posting to taxpayer accounts. |
| **Tax Year** | The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year. |

## Appendix V

# Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

JUN 27 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: for Mary Beth Murphy Dretha Barham
Commissioner Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Has Improved Processing and Review of Small Business Health Care Tax Credit Claims; However, Use of the Credit Has Decreased Significantly (Audit # 201530336)

Thank you for the opportunity to review and comment on the subject draft audit report. In 2010, Congress enacted the Small Business Health Care Tax Credit (SBHCTC) to reimburse eligible small employers for a portion of their employee health insurance expenses. Beginning in tax year 2014, eligible employers can only claim the credit for two consecutive years.

We appreciate your acknowledgement of our improved and enhanced administration of the SBHCTC through pre-filing math error checks, which allow us to adjust or disallow improperly claimed credits during processing and through the development of post-filing filters to identify returns with potential errors for further evaluation. As TIGTA's analysis shows, we have significantly decreased the number of SBHCTCs allowed in error.

Your report notes that our examiners are correctly considering the credit during examinations when appropriate. Your review of this process found an opportunity for improvement of our post processing filters. We agree with your recommendation and will refine the post processing filters to identify Small Business/Self-Employed (SB/SE)) returns with the highest risk of material non-compliance related to the Internal Revenue Code Section 45R credit.

Attached is a detailed response outlining our corrective action to address your recommendation. If you have any questions, please contact me, or a member of your staff may contact Brenda Dial, Director, Examination, SB/SE Division at (240) 613-2849.

Attachment

Attachment

**RECOMMENDATION 1:**
The Director, Examination, SB/SE Division, should review post-processing filters designed to identify potentially questionable issues related to the credit and correct programming issues when errors are identified.

**CORRECTIVE ACTION:**
We agree with this recommendation. SB/SE Exam Case Selection (ECS) is in the process of analyzing each filter to determine if it is performing as intended. ECS identified several filters that needed correction and is working with IT to make corrections for the current year. We will continue monitoring the filters and the 2017 returns, filed in 2018, to determine if further corrections are necessary. ECS will share its recommendations for business master file filter changes with Tax Exempt and Government Entities (TE/GE) as it co-owns the filters. If SB/SE and TE/GE agree filters should be modified or discontinued, SB/SE will submit necessary Unified Work Requests (UWR).

**IMPLEMENTATION DATE:**
June 15, 2018

**RESPONSIBLE OFFICIAL:**
Director, Exam Case Selection, Small Business/Self-Employed Division

**CORRECTIVE ACTION MONITORING PLAN:**
IRS will monitor this corrective action as part of our internal management system of controls.